

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

77-5036

To be argued by
MICHAEL R. KLEINERMAN

United States Court of Appeals
FOR THE SECOND CIRCUIT

IN RE EASTERN FREIGHT WAYS, INC.,
Bankrupt,

SIDNEY B. GLUCK, Trustee in Bankruptcy of
EASTERN FREIGHT WAYS, INC.,
Plaintiff-Appellee,

—against—

SEABOARD SURETY COMPANY,
Defendant-Appellant,

MANUFACTURERS HANOVER TRUST COMPANY, individually and
as agent for other institutional lenders, INTERNATIONAL
HARVESTER CREDIT CORPORATION, FRUEHAUF CORPORATION
and THE CHASE MANHATTAN BANK, NATIONAL ASSOCIATION,
and THOMAS J. CAHILL, Trustee in Bankruptcy of
ASSOCIATED TRANSPORT, INC.,
Defendants-Appellants

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

**BRIEF OF PLAINTIFF-APPELLEE SIDNEY B. GLUCK
TRUSTEE IN BANKRUPTCY OF
EASTERN FREIGHT WAYS, INC.**

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February 29, 1978

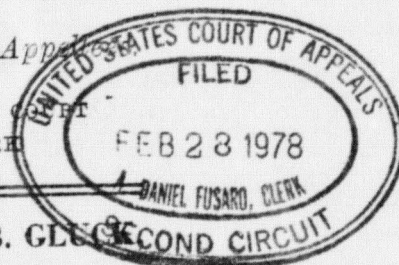


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-against-

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TER CREDIT CORPORATION, FRUEHAUF CORPORATION and THE CHASE
MANHATTAN BANK, NATIONAL ASSOCIATION, and THOMAS J. CAHILL,
Trustee in Bankruptcy of ASSOCIATED TRANSPORT, INC.,

Defendants-Appellees.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF PLAINTIFF-APPELLEE SIDNEY B. GLUCK,
TRUSTEE IN BANKRUPTCY OF EASTERN FREIGHT WAYS, INC.

PRELIMINARY STATEMENT

This brief is submitted on behalf of Sidney B.
Gluck, trustee in bankruptcy of Eastern Freight Ways, Inc.

(the "Trustee" and "Eastern," respectively) in opposition to the appeal of Seaboard Surety Company ("Seaboard") from the opinion and order of Hon. Edmund L. Palmieri, District Judge, dated October 31, 1977 (R 662a).^{*} His decision affirmed the order of Hon. Roy Babitt, Bankruptcy Judge, signed on May 27, 1977 (R 543a), following his opinion filed on April 7, 1977 (R 531a).

The Trustee, fully agreeing with District Judge Palmieri, will show that the substantive position of Seaboard is without merit, that its jurisdictional argument is misplaced, and that the order appealed from should be affirmed and the appeal dismissed.

ISSUES PRESENTED FOR REVIEW

1. Whether Seaboard, as surety, has the equitable right to invite former shipping customers of Eastern, its bankrupt principal, to set off against their claims for cargo loss or damage submitted to Seaboard by such customers, amounts owed by them to Eastern for freight charges when Seaboard has recourse to the proceeds in its possession of a \$2,000,000 irrevocable letter of credit issued for the benefit of Seaboard for the express purpose of paying such claims for cargo loss or damage.

^{*}References so indicated are to pages of the Record on Appeal.

The District Court determined that Seaboard had no such equitable right to invite such setoffs and affirmed (i) the issuance by the Bankruptcy Court of its permanent injunction restraining Seaboard from so inviting until it exhausted the \$2,000,000 fund, and affirmed (ii) the declaratory judgment in favor of the Trustee and concomitant denial of Seaboard's motion to dismiss the first and third causes of action of the Trustee's complaint in the adversary proceeding below.

2. Whether the Bankruptcy Court, having jurisdiction to determine whether such equitable right to invite setoffs exists and to issue such injunction, has jurisdiction to conduct a hearing to decide whether Seaboard is entitled to exhaust the \$2,000,000 fund by paying claims of Eastern customers only, or claims of customers of Associated Transport, Inc. ("Associated") also.

The District Court determined that the jurisdiction of the Bankruptcy Court to determine such rights and issue such injunction includes jurisdiction to conduct a hearing to so decide.

STATEMENT OF THE CASE

A. The Facts

District Judge Palmieri summarized the facts concisely (R 663a-665a):

"The facts of the case can be stated briefly. Eastern Freight Ways, Inc. ('Eastern') and Associated Transport, Inc. ('Associated') were licensed common carriers of freight under the regulatory authority of the Interstate Commerce Commission. In accordance with the Commission's regulations, Eastern and Associated were authorized to act as self-insurers against cargo losses sustained by their shipping customers. Eastern gained control of Associated in 1974 and, upon authorization of the ICC, was operating and managing its affairs.

"Prior to 1974, Associated had caused Seaboard to issue bonds in connection with its liability as self-insurer to third parties relating to its shipping business. After Eastern gained control of Associated, both companies began to do business with Seaboard. In September 1974, a number of agreements were executed among these companies, the precise legal effect of which remains to be ascertained. These included: 1) a 'Collateral Agreement', under which Eastern and Associated agreed to provide collateral for Seaboard's exposure under any bonds issued or to be issued on behalf of Eastern or Associated;* 2) a 'General Agree-

*Seaboard, in its brief to this Court (the "Seaboard Brief"), stated that the Collateral Agreement (R 359a) provided that the letter of credit would be furnished to Seaboard to secure it on bonds written for Eastern and/or Associated (Seaboard Brief at 4). This statement is wholly inaccurate. The Collateral Agreement contains no mention of any letter of credit, and simply refers to cash or securities to be furnished as collateral. Seaboard thus persists in repeating its interpretation of a disputed issue of fact to persuade the courts that the letter of credit secured Seaboard's obligations on bonds written for Eastern and Associated. This stance is somewhat inconsistent since Seaboard also challenges the jurisdiction of these courts to determine this very issue.

ment of Indemnity', under which Eastern and Associated agreed to indemnify and hold Seaboard harmless against liabilities incurred by Seaboard under such bonds; and 3) a letter of credit which Eastern procured from the Chase Manhattan Bank, N.A. ('Chase') from which Seaboard was authorized to draw up to \$2,000,000 by sight draft and upon written certification that it had 'not been released from liability under the surety bond(s) or undertaking(s)...executed on behalf of Eastern...' During this same period Seaboard issued bonds on behalf of Eastern in connection with its liability as self-insurer to third parties for bodily injury, property damage, workmen's compensation, and the like.

"Subsequent to the above arrangements, Eastern entered into various security agreements with Manufacturers Hanover Trust ('Manufacturers'), International Harvester Credit Corporation ('International Harvester'), and Fruehauf Corporation ('Fruehauf'), conveying to these companies security interests in Eastern's accounts receivable.

"Eastern and Associated filed petitions for arrangement under Chapter XI of the Bankruptcy Act on April 22, 1976 and both were adjudged bankrupt on April 28, 1976. (Eastern briefly re-entered Chapter XI in June of 1976, but was again adjudged bankrupt on August 24, 1976.) Sidney B. Gluck, plaintiff below, was appointed trustee in bankruptcy of Eastern ('Eastern trustee'), and Thomas J. Cahill was appointed trustee in bankruptcy of Associated ('Associated trustee').

"When Eastern filed its Chapter XI petition, approximately 20,000 unpaid cargo claims had been presented to Seaboard, many of which were asserted by claimants who owed freight charges to Eastern. On August 28, 1976, when Eastern and Associated were finally adjudged bankrupt, Seaboard delivered its certification to Chase, took down the proceeds of the letter of credit, and began to use such proceeds to satisfy claims on the

bonds which it had written for both Eastern and Associated. Seaboard also began sending letters to the shipping customers of Eastern and Associated, advising them that they could set off sums they owed for freight charges against cargo claims they asserted against those companies and that Seaboard would not be responsible for more than the difference between the two." (Emphasis added).

The Trustee challenged this interference by Seaboard with the collection of the accounts receivable of Eastern by instituting this litigation.

B. The Litigation

When the Trustee learned that Seaboard was sending letters inviting former shipping customers of Eastern to deduct from their claims against Seaboard the amounts they owed for shipping charges, he applied, in September 1976, to the Bankruptcy Court for a temporary restraining order (R 7-10a) and other relief. The application, authorized by Rule 765 of the Rules of Bankruptcy Procedure (hereinafter cited as "Bankruptcy Rule ____"), was granted, and by order dated November 5, 1976, such temporary restraining order was continued pending a hearing to determine whether a permanent injunction restraining such invitations should be issued.

At approximately the same time, on November 3, 1976, the Bankruptcy Court issued a summons and notice of hearing in connection with an adversary proceeding commenced

by the Trustee against Seaboard and the other defendants in this matter. The adversary proceeding was authorized under Bankruptcy Rule 701 to determine the validity, priority and/or extent of a lien or other interest in property of the bankrupt.

District Judge Palmieri accurately summarized the litigation in the Bankruptcy Court (R 665-666a):

"The present adversary proceeding was commenced on November 3, 1976, by the filing of the Eastern Trustee's complaint which pleaded three causes of action. The first sought, inter alia, a determination that, because of the prior assignments of the accounts receivable, Seaboard could not invite set-offs from Eastern's customers. The second, which was dismissed by the Bankruptcy Judge and is not the subject of any appeal or cross-appeal, sought damages for Seaboard's alleged conversion of Eastern's accounts receivable. The third cause of action set forth two requests for relief: first, a declaration that the proceeds of the letter of credit are to be used by Seaboard to satisfy only claims under bonds written for Eastern, and second, a judgment that Seaboard must first exhaust the proceeds of the letter of credit before being able to take advantage of any alleged right to invite set-offs.

"All of the defendants except Seaboard answered, most of them asserting cross-claims against Seaboard. Seaboard moved to dismiss the first and second causes of action of the complaint and related cross-claims for failure to state claims upon which relief could be granted; it also moved to dismiss the third cause of action and related cross-claims on the ground that the Bankruptcy Court lacked jurisdiction to grant the relief requested.

"A hearing was held on December 13, 1976 and Judge Babitt of the Bankruptcy Court rendered an opinion on April 7, 1977, which in essence denied Seaboard's various motions to dismiss (except as to the second cause of action), awarded declaratory relief to the Eastern trustee to the effect that no setoff can be claimed by Seaboard until the proceeds of the letter of credit are exhausted, made permanent a temporary injunction restraining Seaboard from sending letters to Eastern's customers, and set down an evidentiary hearing on the proper allocation of the proceeds of the letter of credit. The latter hearing was stayed pending the resolution of this appeal. The Bankruptcy Judge did not reach the allegations of the first cause of action and related cross-claims, finding that his resolution of the third cause of action disposed of the case. Seaboard was granted 'leave to return...at such time when it appears that it is a no-recourse position.' An order was entered on May 27, 1977, in accordance with this opinion."

Seaboard promptly appealed to the Southern District and, after the submission of briefs and oral argument, District Judge Palmieri rendered the decision from which Seaboard now appeals.

For the reasons developed in Points I and II of this brief, the Trustee will show that District Judge Palmieri was eminently correct in affirming the decision of Bankruptcy Judge Babitt.

POINT I

THE RECOURSE OF SEABOARD TO THE PROCEEDS
OF A \$2,000,000 LETTER OF CREDIT PREVENTS
THE CLAIMED EQUITABLE RIGHT OF SEABOARD
TO INVITE SETOFFS FROM MATURING

The Yale Express Case

A. General

The controlling authority in this circuit, In re Yale Express System, Inc., 362 F.2d 111 (2d Cir. 1966), relied on below by Seaboard, briefed below by the Trustee, and cited below by both courts, in its own terms "raises interesting questions of the rights of a surety in bankruptcy, some of which are only dimly illumined by the case law." 362 F.2d at 113. The facts of Yale Express, the underlying case law, and the reasoning of this Court, thus bear critically on the issue of this appeal.

B. The Facts

The Chapter X debtor in Yale Express was a motor carrier ("Yale") insured by Boston Insurance Company ("Boston Insurance") against liability to Yale's shipping customers for cargo loss or damage. After the filing of its Chapter X petition, Yale had some 22,000 pending claims for such loss or damage, many of which were made by shipping customers owing freight charges.

The Chapter X trustee notified the shipping customers that, while he could not pay their pre-petition claims, Boston Insurance was directly obligated to pay them within the insurance policy limits. When the shipping customers asserted their claims against Boston Insurance, it sent letters to such claimants indicating a willingness to honor their claims subject to the right of Boston Insurance to deduct from the amounts of their claims any outstanding freight charges owed to Yale.

C. The Decision

The Southern District determined that Boston Insurance had no right to invite setoffs [In the Matter of Yale Express System, Inc., 251 F.Supp. 447 (S.D.N.Y. 1965)], but the Second Circuit reversed. The instructive opinion of Judge Friendly shows that it was not the superficial insolvency of Yale that gave rise to the right of invitation, but rather, the underlying lack of recourse by Boston Insurance against Yale resulting from its insolvency and in an enrichment of Yale's estate at the surety's expense.

D. The Issue

The precise legal issue involved in Yale Express and at bar does not concern the equitable doctrine of setting off mutual debts between bankrupt debtors, such as Eastern, and their creditors, such as its shipping customers, codified in Bankruptcy Act §68a, 11 U.S.C.A. §108(a).

Yale Express and this case deal with the equitable right of a surety to cause, somehow, a reduction in the claims against it by deducting from the amounts of such claims the sums owed by the claimants to an insolvent debtor. Yale Express, upon which Seaboard relies (Seaboard Brief at 8), so defined the issue:

"What Boston is in fact asserting is that as a surety it is equitably entitled to require the trustee to require the shippers to apply their security, to wit their indebtedness for freight, for Boston's benefit in the only way in which this particular form of security can be applied, by reducing the claims against both principal and surety. This equitable right of the surety may be viewed either as one to have the creditor required to do what his self-interest would lead him to do but for the existence of the surety, or as one to have the estate of the insolvent principal required to make the setoff available to the surety. In the latter aspect it has all the characteristics of an equitable lien (citation omitted)." 362 F.2d at 115.

District Judge Palmieri agreed with the Trustee's statement of the issue:

"It should be noted at this point that the issue in this case, and in Yale Express, is not the equitable right of bankrupt debtors and their creditors (such as Eastern and its shipping customers) to set off mutual debts, but rather the alleged right of the bankrupt's surety to solicit and take advantage of such setoffs." (R 667a.)

E. Legal Analysis

Judge Friendly, in Yale Express, approached the resolution of this issue by first stating the general rule that, so long as the principal is solvent and therefore able to respond to its surety's claim for exoneration, the surety can neither compel the principal to assert a counterclaim against third party creditors of the principal in the surety's exoneration nor use the principal's counterclaim when sued by such creditors. 362 F.2d at 114. [See also United States ex rel. Johnson v. Morley Const. Co., 98 F.2d 781 (2d Cir. 1938).] In such instances, the equitable right of a surety to invite setoffs clearly would not exist.

Judge Friendly then recognized that, in applying this general rule, courts have held that where the principal's insolvency impairs the surety's right of exoneration against the principal, the surety may use the setoff of the principal's claim against the creditor. Clark Car Co. v. Clark, 48 F.2d 169 (3d Cir. 1931). The reason for the surety's right to use the setoff where the principal is insolvent had been explained by Judge Learned Hand in the Morley case, from which Judge Friendly quoted extensively:

"If the creditor then recovers from the surety, the surety has no recourse over against the principal, but must bear the loss except for such dividends as he may get in the insolvency proceedings. Yet having recovered from the surety and real-

ized upon his claim, the creditor is without set-off when sued on the counterclaim by the principal's trustee or receiver, and the recovery goes to swell the estate. Had the creditor not sued the surety, he could, and of course, would, have used the claim as a set-off against the counterclaim. Thus, the upshot of denying the surety a right to assert the counterclaim is to enhance the principal's estate at the expense of the surety, which is contrary to the fundamental relation between the two.' 98 F.2d at 790." 362 F.2d at 115. (emphasis added).

As Bankruptcy Judge Babitt recognized, "[i]t was clear that in Yale Express the surety had no recourse against the debtor, and that its only means of recovery was through a right of setoff." (R 540a) (emphasis added). Applying the rule that the surety is equitably entitled to use the right of setoff when its principal's insolvency leaves the surety without recourse, this Court held that Boston Insurance in Yale Express could use the setoff of unpaid freight charges due from shipping customers against cargo claims made on it. This Court did not then consider, nor should it have, a situation where the principal is insolvent and the surety nevertheless has recourse.

Such is the case at bar. The surety, Seaboard, has full recourse against the \$2,000,000 fund. To the extent such recourse is exercised, Eastern's estate will not be enhanced at Seaboard's expense.

Therefore, according to the reasons for the rule of Yale Express, one of a line of cases of impeccable auth-

ority, Seaboard's equitable right to invite setoffs does not mature until Seaboard lawfully exhausts the \$2,000,000 fund or lawfully causes its non-existence. Only then, when Eastern's estate may indeed be enriched at Seaboard's expense, does Eastern's insolvency become relevant.

District Judge Palmieri agreed with Bankruptcy Judge Babitt and the Trustee:

"Finding that the surety in the present case does have recourse--namely, the proceeds of the two million dollar letter of credit--and therefore that the principal's estate would not be enriched at the surety's expense, the Bankruptcy Judge concluded that it could not claim any right of setoff until such time as the proceeds of the letter of credit are exhausted.

"This conclusion was eminently correct. It must not be forgotten that we are concerned here with equitable considerations, not with inflexible legal rules. Judge Babitt properly went beyond the 'mere insolvency of the principal' to the 'underlying rationale for the exception', namely, the impairment of the surety's right of exoneration. No injustice is done to the surety hereby by requiring it to seek its exoneration in the collateral apparently established for that very purpose. Moreover, its rights are protected by the Bankruptcy Judge's grant of leave to return at such time that it appears that Seaboard can make the requisite showing that its collateral is inadequate or has been properly exhausted. In light of these considerations, and given the undeveloped state of the evidence as to both the actual and the proper disposition of the proceeds of the letter of credit by Seaboard, it would be inappropriate for this court to overturn the Bankruptcy Judge's decision." (R 668a).

Other Cases

Other cases support the proposition that it is the absence of recourse against an insolvent principal, the impairment of the right of exoneration, rather than the superficial insolvency of the principal, which may entitle a surety to the equitable right to invite setoffs.

This Court, in Yale Express, cited Clark Car Co. v. Clark, 48 F.2d 169 (3d Cir. 1931), which holds as follows:

"The general rule of law is that, where a surety alone is sued, in the absence of statute permitting it, he cannot avail himself of any claim of his principal against the creditor where he has not interest in the claim. The surety must pay the claim and look to his principal for reimbursement. But where there are special circumstances, such as the insolvency of the principal, which would make it inequitable to deny the set-off, it will be allowed. When the surety has no recourse to his principal, it would be inequitable to deprive him of what was a perfectly good set-off between the principal and his creditor." 48 F.2d at 170 (citations omitted, emphasis added).

In Tidewater Coal Exchange, Inc. v. New Amsterdam Casualty Co., 20 F.2d 951 (D.C. Del. 1927), the court explained:

"Exceptions to the rule are, however, sometimes made for the enforcement of certain equities existing in favor of a surety, and which would otherwise be irremediable." 20 F.2d at 954. (emphasis added).

Similarly, in Shannon v. Sutherland, 74 F.2d 530 (4th Cir. 1935), the court held:

"...the remedy of equitable set-off may be enforced...where, from the nature of the claim, or from the situation of the parties, it is impossible to obtain justice by plea or cross-action." 74 F.2d at 531. (emphasis added).

"No recourse," "irremediable," "impossible to obtain justice"--these are the judicial touchstones that test the equitable right of a surety to invite or claim set-offs when its principal is insolvent.

This Case - Conclusion

In the case at bar two distinguished jurists have held that the equitable right to invite setoffs does not mature until Seaboard exhausts the \$2,000,000 fund which it procured to guard against the insolvency of its principal. Only then may Seaboard satisfy criteria developed in an impressive line of decisions; only then will Seaboard be without recourse; only then may the estate of Eastern benefit at Seaboard's expense; and only then is there the possibility of any harm to Seaboard. Until that time, Seaboard must content itself with properly exhausting the \$2 000,000 fund for its expressly intended purpose, rather than sending letters which hamper the Trustee's inherently difficult task of collecting the accounts receivable of the bankrupt.

Accordingly, for all of the foregoing reasons, the Trustee requests this Court to affirm the substantive aspects of the opinion and order below.

POINT II

THE UNDISPUTED JURISDICTION OF THE BANKRUPTCY COURT (I) TO DECLARE THAT SEABOARD HAS NO EQUITABLE RIGHT TO INVITE SETOFFS AND (II) TO ENJOIN SUCH INVITATIONS, UNTIL THE \$2,000,000 FUND IS EXHAUSTED, INCLUDES THE JURISDICTION TO CONDUCT AN EVIDENTIARY HEARING TO DETERMINE WHETHER SEABOARD IS ENTITLED TO EXHAUST THE FUND BY PAYING CLAIMS OF EASTERN CUSTOMERS ONLY, OR CLAIMS OF ASSOCIATED CUSTOMERS ALSO

In this proceeding, the fundamental basis of the jurisdiction of the Bankruptcy Court is its constructive possession of the accounts receivable of Eastern. Thompson v. Magnolia Petroleum Co., 309 U.S. 478 (1940); 2 Collier, Bankruptcy ¶23.05[1] (14th ed. 1976).

Challenging the interference by Seaboard with the collection of these accounts receivable, the Trustee sought injunctive relief under Bankruptcy Rule 765 and commenced an adversary proceeding under Bankruptcy Rule 701. There is no dispute that the Bankruptcy Court has jurisdiction in both proceedings to determine whether Seaboard was interfering with the accounts receivable of Eastern by inviting former customers to deduct from their claims against Seaboard the amounts owed by them to Eastern for shipping charges (R 760a).

In determining this issue, the Bankruptcy Court held that:

"...until the proceeds of the letter of credit are exhausted, no right of setoff can be claimed by Seaboard, and the trustee is entitled to a declaratory judgment to that effect." (emphasis added, R 541a).

* * *

"...the injunction pendente lite heretofore granted against further solicitation by Seaboard is made permanent until such time as Seaboard can make the requisite showing that it finds itself in the position of the surety in Yale Express." (emphasis added, R 541a).

In the courts below, Seaboard raised a jurisdictional argument that had the effect of bifurcating the issues. Seaboard was satisfied to have the Bankruptcy Court decide one side of the case--its right to invite setoffs--but urged that the Court lacked jurisdiction to determine the critical question of the proper use of the proceeds of the letter of credit. The Trustee has urged that the presence of the letter of credit of necessity changed the result in Yale Express.

Seaboard has now reduced its jurisdictional argument to the contention that while the Bankruptcy Court admittedly has jurisdiction to render such declaratory judgment and to issue such qualified permanent injunction, the Bankruptcy Court lacks jurisdiction to determine whether the proceeds have been "exhausted" and whether such "requisite showing" has been made. This is so, Seaboard argues, be-

cause any such determination, affecting the proceeds of the letter of credit in Seaboard's possession to which Seaboard asserts a substantial, adverse claim, is necessarily outside of the jurisdiction of the Bankruptcy Court (Seaboard Brief at 30).

This argument fails. The Trustee makes no claim to the proceeds of the letter of credit in Seaboard's possession. Any determination by the Bankruptcy Court will not affect these proceeds. While Seaboard's recourse to the \$2,000,000 fund is the juridical fact which transmutes its potential right to invite setoffs into an illegal interference with assets of Eastern concededly under the jurisdictional umbrella of the Bankruptcy Court, the instant Bankruptcy Rule 701 and 765 proceedings are not actions which seek to compel Seaboard to return any part of the proceeds to the Trustee. The proceedings were brought to protect assets from interference by the premature assertion of an equitable right which happens not to arise until an event occurs, namely, the proper exhaustion of the proceeds as authorized by underlying documents.

District Judge Palmieri explained this point as follows:

"The trustee's right to prevent Seaboard from inviting setoffs and thereby interfering with assets in his constructive possession (the accounts receivable) arises, in part, from the availability to

Seaboard of proceeds of a letter of credit. 'Availability' must not be understood in a physical sense, but rather in a legal one: the funds which impede Seaboard's alleged right to setoffs are only 'available' to it if, given the proper use of such funds, there remains a reservoir from which Seaboard can continue to draw in paying claims under its bonds. Whether the actual money has been exhausted is irrelevant; what is determinative is whether those expenditures permitted by the terms of the contracts to which the parties had bound themselves--and only those expenditures--have been of sufficient magnitude to exhaust the \$2,000,000 drawn down from the issuer of the letter of credit. What Seaboard has actually spent is thus not the question; the question is what Seaboard was entitled to have spent, given a proper interpretation of the contractual terms and associated instruments, and whether such authorized expenditures have exhausted the proceeds. This latter question, upon the resolution of which depend the rights of the parties as to the setoffs, requires an examination and interpretation of the parties' rights in and to these proceeds, and in particular, a determination of whether such proceeds must be used solely to satisfy claims under bonds written by Seaboard for Eastern, as alleged in the complaint.

"It appears, then, that the Bankruptcy Judge properly assumed jurisdiction to decide these questions upon the scheduled evidentiary hearing. Whether, after such hearing, the Bankruptcy Court would have jurisdiction to compel any particular use of the physical proceeds or issue any other orders which cannot directly be predicated on his jurisdiction over the setoff issue is another question. Because it is not yet clear just what additional matters the Bankruptcy Judge intends to reach in this case, and because some of the parties, including the Eastern trustee, have taken positions in their briefs apparently disclaiming any assertion of jurisdiction over the proceeds themselves¹, these questions must abide the further course of this litigation." (emphasis added, R 673).

An analysis of the injunctive aspects of Bankruptcy Judge Babitt's decision demonstrates the propriety of District Judge Palmieri's affirmance.

The Bankruptcy Court is a court of equity. Bankruptcy Act §2(a), 11 U.S.C.A. §11(a). See also Bank of Marin v. England, 385 U.S. 99 (1966). Courts of equity, as articulated by Justice Cardozo, have "...the power...to modify an injunction in adaptation to changed conditions...by force of principles inherent in the jurisdiction of the chancery." United States v. Swift & Co., 286 U.S. 106, 114 (1932). This is especially so where "...power to modify the decree was reserved by its very terms, and so from the beginning went hand in hand with its restraints." Ibid.

Thus, in the case at bar, the reservation of power by the Bankruptcy Court to modify its injunctive decree was jurisdictionally sound and appropriate; so was conditioning modification on the "requisite showing" by Seaboard that it no longer had recourse to the proceeds of the letter of credit. "Clearly [the Bankruptcy] Court has jurisdiction to determine whether the conditions set forth in its injunctive order have been met." Chicago & Eastern Illinois Railroad Co. v. Illinois Central Railroad Co., 261 F.Supp. 289, 308 (N.D. Ill. E.D. 1966). See also King-Seeley Thermos Co. v. Aladdin Industries, Inc., 418 F.2d 31 (2d Cir. 1969); 7 Moore, Federal Practice ¶¶60.16[6], 60.26[4] (2d ed. 1975); Bankruptcy Rule 765.

Under these principles, it is clear that on vacating or modifying its injunction the Bankruptcy Court has jurisdiction to determine whether Seaboard has met the condition of exhausting proceeds it is entitled to expend. Similarly, the Bankruptcy Court had jurisdiction to render its declaratory judgment.

This jurisdiction is based on the Bankruptcy Court's constructive possession of Eastern's assets, particularly its accounts receivable. Such possession is the jurisdictional foundation for the action of the Bankruptcy Court in enjoining Seaboard and granting declaratory relief. In the final analysis, such possession is also the jurisdictional basis for the Bankruptcy Court to hold the evidentiary hearing in question. There is no independent basis of jurisdiction; nor are there extrinsic facts, such as the possession by Seaboard of the proceeds, which deprive the Court of such jurisdiction. Accordingly, the jurisdictional aspects of District Judge Palmieri's opinion and order should also be affirmed.

CONCLUSION

For the reasons advanced in Points I and II, the opinion and order of District Judge Palmieri from which Seaboard appeals should be affirmed, and the appeal dismissed.

Dated: February 28, 1978

Respectfully submitted,

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